F. STATE INSTITUTIONS - INSTRUMENTALITIES

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1. Introduction

This article discusses instrumentality terminology, recent Internal Revenue Manual material on instrumentalities, and a significant announcement on instrumentality filing requirements. This article also discusses the four major issues in handling an instrumentality exemption application. This topic was previously addressed in the 1990 CPE text under the heading of INSTRUMENTALITIES.

2. Terminology

A fire department, public library, hospital district, state college, or port authority are examples of state institutions that may be created, controlled by, or closely affiliated with government. And their income may be exempt from federal income tax pursuant to IRC 115(a), (see Appendix), except for unrelated business income tax for certain state colleges and universities under IRC 511(a)(2)(B). Nevertheless, each may also qualify for exemption as a clear counterpart of an organization described in IRC 501(c)(3), if it is not an integral part of a state or a political subdivision, and it otherwise satisfies the organizational and operational tests. The term "instrumentality" has been applied to this type of organization as a kind of shorthand. Technically the term "instrumentality" only has application under the FICA and FUTA (social security tax) provisions. However, for convenience, this article will also refer to these organizations affiliated with governments as instrumentalities.

3. Changes to IRM

We revised IRM 7751-34(12), Exempt Organizations Handbook, to provide information on exemption and other issues involving instrumentalities.

We also revised IRM 7664.31(2) to provide that, after consideration of IRM 7751-34(12), only those applications submitted by instrumentalities of states or political subdivisions where an adverse determination is contemplated are to be referred by the Key District to Headquarters for handling. Therefore, Key Districts may now process most instrumentality exemption applications.

4. Announcement 94-117, 1994-39 I.R.B. (September 26, 1994)

This announcement issues, in proposed form, a revenue procedure that would exercise the discretionary authority under IRC 6033 to except certain organizations that are closely affiliated with governmental units from the requirement to file annual information returns (Form 990). If the proposed revenue procedure is published in final form, a significant number of organizations will be excepted from filing returns.

Many organizations do not realize the filing requirement that comes with obtaining exemption. Currently, the only specific exception is found in Reg. 1.6033-2(g)(v), which provides that an annual information return is not required from an organization exempt from federal income tax under IRC 501(a) that is a state institution, the income of which is excluded from gross income under IRC 115(a). Application of this provision is dependent on the organization obtaining a ruling under IRC 115(a), which is within the jurisdiction of the Associate Chief Counsel (Domestic).

5. Major Issues Faced In Handling Exemption Applications

The four major issues faced in handling exemption applications of instrumentalities are (A) Is the instrumentality a separately organized entity, (B) Is the instrumentality an integral part of the state or municipal government, (C) Does the instrumentality meet the organizational test, and (D) Does the instrumentality possess a disqualifying regulatory power. Each of these issues is discussed below.

A. Separately Organized Entity

Rev. Rul. 60-384, 1960-2 C.B. 172, in amplifying Rev. Rul. 55-319, C.B. 1955-1, 119, held that a wholly-owned state or municipal instrumentality that is a separate entity and is organized and operated exclusively for purposes described in IRC 501(c)(3), may qualify for exemption. To qualify for exemption, however, a wholly-owned state or municipal instrumentality must establish that it is a separately organized entity. G.C.M. 34502 (May 21, 1971) addresses the requirements a wholly-owned state or municipal instrumentality must meet to be considered a separately organized entity.

The separately organized entity requirement is generally met if the instrumentality is incorporated under a state non-profit corporation law. This is so

because as a legal entity, created under state law, a corporation is regarded as having an existence separate and apart from that of its creators. Likewise, if the instrumentality is organized and operated as a trust, it is regarded as legally separate from its governmental creator. A problem arises, however, in applying the separate entity principle established in Rev. Rul. 60-384, when an instrumentality is neither a corporation nor a trust.

Even if not incorporated under state law, any entity that is considered a "corporation" for federal tax law purposes will be considered a separately organized entity. IRC 7701(a)(3) provides that the term "corporation" includes associations. Reg. 301.7701-2 lists six major characteristics that are ordinarily found in a pure corporation, which, taken together, distinguish it from other organizations. Since some of these corporate characteristics are not relevant to unincorporated nonprofit bodies, they have been administratively adapted to cases involving classification of nonprofit organizations. As adapted, the characteristics are: (i) associates, (ii) an objective by the associates to carry on the activity for which the organization was formed, (iii) continuity of life, (iv) centralized management, (v) limited liability, and (vi) free transferability of interests. An instrumentality will be treated as an association if it has a sufficient number of the corporate characteristics such that the instrumentality more nearly resembles a corporation than a partnership, trust, or mere aggregation of individuals. If so, it will be considered a separately organized entity both for purposes of IRC 501(c)(3) and Rev. Rul. 60-384.

The corporate characteristics, as adapted to cases involving classification of nonprofit organizations, allow a very broad category of nonprofit entities to be considered "corporations" for federal tax purposes, and hence "separately organized" under Rev. Rul. 60-384. Examples include colleges and universities; hospital, housing, or development districts or authorities; public library boards; water or park districts; public school athletic associations; and organizations created by inter-governmental agreement. Following are two illustrations:

> **Example 1** A hospital district was created by state legislation. The legislation stated that the hospital district was established for the purpose of furnishing hospital and medical care to the needy inhabitants in one of the counties of the state and provided for the hospital district to purchase certain hospital facilities. The legislation also provided that the hospital district would not be created until it was approved by a majority of the county voters. The legislation named the temporary directors and provided that they would become

permanent directors, if the creation of the hospital district was approved by the voters. The legislation provided that the board of directors could appoint an administrator of the hospital district. The voters of the county approved the creation of the hospital district.

The separate organization requirement was met in that the hospital district resembled a corporation, as it possessed four characteristics that are attributable to corporations under Reg. 301.7701-(2). These are (i) associates (board of directors), (ii) an objective to carry on the activities in furtherance of the charitable purpose for which it was formed (providing healthcare services to county residents), (iii) continuity of life (board of directors continued in existence and was not affected by death, resignation, retirement, etc. of any of its members), and (iv) centralization of management (legislation provided for appointment of an administrator).

Example 2 A state statute authorized each municipal corporation in the state to activate a development authority to promote and develop trade, commerce, industry and employment opportunities. The statute provided that each such authority would be a public body corporate and politic, consisting of seven directors. The statute authorized the governing body of the municipal corporation to appoint the initial board of directors and their successors and provided the directors with the power to appoint an executive director. The statute further provided that no authority shall transact any business until the municipal corporation's governing body activated the authority by resolution by designating the downtown development area and appointing the initial directors. The resolution activating the authority was adopted by the city council and approved by the mayor. The statute provided that such resolution be filed with the secretary of state.

The separate organization requirement was met in that the development authority resembled a corporation, as it possessed more corporate characteristics than noncorporate characteristics. These are (i) associates (seven board members), (ii) an objective by the associates to carry on the development authority's activity, separate and apart from the general activity of the government, (iii) continuity of life (board of directors continued in existence and was not affected by death, resignation, retirement, etc. of any of its members), and (iv) centralized management (statute provided for appointment of executive director). Thus, the development authority possessed four of the six corporate characteristics listed in

Reg. 301.7701-2. Further, the development authority was activated under a state statute as a public body corporate and politic, and the resolution, adopted by the city council and approved by the mayor, was filed with the secretary of state.

B. Integral Part

Rev. Rul. 60-384 established that a state or municipality itself does not qualify as an organization described in IRC 501(c)(3), as its purposes are clearly not exclusively those described in IRC 501(c)(3) of the Code. This revenue ruling further established that an integral part of a state or municipal government is treated the same as the government of which it is a part and, therefore, does not qualify as an IRC 501(c)(3) organization. For example, a public school, college, university or hospital, which is an integral part of a local government, does not meet the requirements for exemption under IRC 501(c)(3). Also, if a particular branch or department under whose jurisdiction the activity in question is being conducted is an integral part of a state or municipal government, the provisions of IRC 501(c)(3) are not applicable.

Determining whether an organization is an integral part of a state or municipal government requires consideration of the particular facts. If a state is substantially involved in the activities of an organization, that organization will be considered an integral part of the state or municipal government. Factors that indicate state involvement include (1) creation of the organization by executive order of the governor of a state, (2) creation of the organization by executive order of the governor of a state as an official state agency, (3) a state or a state agency having the power to appoint and remove the organization's board, (4) a state or a state agency having the power to abolish the organization, (5) a state or a state agency monitoring the organization's activities, and (6) the organization using government employees to conduct its activities. Following are examples of substantial state involvement:

> **Example 1** Rev. Rul. 62-66, 1962-1 C.B. 83, held that a committee created by executive order of the governor of a state as an official state agency, to educate the public about the purposes and activities of the United Nations as an instrument of world peace, did not qualify for exemption as an educational organization under IRC 501(c)(3). That revenue ruling concluded that the organization was an "integral part" of the state government and, therefore, under Rev. Rul. 60-384, not described in IRC 501(c)(3).

Example 2 A city ordinance provides for the establishment of an auxiliary police force separate and distinct from the regular force of the police department of the city. The auxiliary police force is made up of not more than fifty active or honorary reserve law enforcement officers under the authority, control, and command of the chief of police. Members of the police reserve must apply in writing on a form prescribed by the chief of police. Membership may be terminated by the chief of police or by resignation. The members of the police reserve are subject at all times to the direction, supervision, and control of the chief of police and assist the regular members of the police department in periods of emergency designated by the chief of police. The chief of police prescribes uniforms and badges for the members of the police reserve and directs the manner in which the same are worn. The facts of this example demonstrate the extent of the chief's control over the auxiliary police force and indicates substantial city involvement in the activities of the organization. Thus, the activities of the police reserve are conducted as an integral part of the government and are not conducted by an organization described in IRC 501(c)(3). See G.C.M. 39004 (June 28, 1983).

Example 3 In a revenue ruling where 501(c)(3) exemption was not an issue, a Lawyer Trust Account Fund was held to be an integral part of the state and not subject to federal income tax. See Rev. Rul. 87-2, 1987-1 C.B. 18. The Fund was created by order of a state supreme court. The court also issued rules for the operation of the Fund, and had the power to abolish the Fund at any time. The Fund was governed by nine members, six lawyers and three public members, each of whom was appointed by the court. The court could remove any board member, with or without cause. The Fund was required to maintain adequate books and records and to make formal reports to the court on a quarterly basis. The administrative functions of the Fund were performed by three state employees who spent a substantial amount of their time so doing. The Fund did not have its own employees. The facts of that case indicated substantial state involvement in the activities of the Fund.

C. Organizational Test

Reg. 1.501(c)(3)-1(b)(1) requires that an organization's enabling document set forth purposes that limit it to exclusively serving one or more exempt purposes.

Reg. 1.501(c)(3)-1(b)(4) provides that an organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose.

Satisfying the organizational test established by the above regulations often poses a problem when an instrumentality is created pursuant to a state statute, a local ordinance, or similar enabling instrument. This is so because the enabling document may contain neither "exclusive purposes" language nor a standard dissolution clause. The situation is further compounded by the difficulty an instrumentality faces in having such an enabling instrument amended. Nevertheless, if a careful reading of an instrumentality's enabling document clearly shows that it will operate exclusively for exempt purposes, it will be deemed to have met that portion of the organizational test. Further, if an enabling document, or in the alternative, a state law, provides that, upon dissolution, all of an instrumentality's assets will be transferred to the state or any political subdivision thereof, it will be deemed to have met that portion of the organizational test. In those cases, absent any clear indication that the assets will be distributed for private use, we will assume that the assets will be used for a public purpose as is required by Reg. 1.501(c)(3)-1(b)(4).

D. Regulatory Powers

Rev. Rul. 60-384 provides that even though a wholly-owned state or municipal instrumentality may be a separately organized entity, it is not entitled to IRC 501(c)(3) exemption, if it is clothed with powers other than those described in IRC 501(c)(3). For example, where an instrumentality exercises substantial regulatory or enforcement powers in the public interest, it will not qualify. These powers are referred to as sovereign powers.

Three generally acknowledged sovereign powers by which the government governs are the power to tax, the power of eminent domain, and the police power. In determining whether a particular power is an enforcement or regulatory power of the type referred to in Rev. Rul. 60-384, the Service construes enforcement or regulatory powers as powers akin to those possessed by governmental agencies to promulgate and enforce standards and modes of conduct. Governance, quite clearly, is not among the purposes described in IRC 501(c)(3). See Estate of John C.F. Slayton, 3 B.T.A. 1343 (1926) and Estate of Shamberg v. Commissioner, 3 T.C. 131, aff'd, 144 F.2d 998 (2d Cir. 1944), cert. denied, 323 U.S. 792 (1945). However, not all government powers are necessarily enforcement or regulatory

powers within the meaning of Rev. Rul. 60-384.

Thus, the fact that an instrumentality has one of the sovereign powers listed above does not automatically preclude it from qualifying under IRC 501(c)(3). For example, many nongovernmental entities such as colleges, hospitals, economic development corporations, and electric or other public utilities have been authorized to exercise a limited power of eminent domain. Rev. Rul. 67-290, 1967-2 C.B. 183, holds that a public hospital that has the power to acquire, through eminent domain, property essential to its purposes, qualifies for recognition of exemption as an organization described in IRC 501(c)(3). Thus, the power of eminent domain, if limited to furthering an organization's charitable purpose, does not constitute an enforcement or regulatory power within the meaning of Rev. Rul. 60-384. Similarly, a limited power to determine a tax rate necessary to support an organization's operations, a power related more to the disposition of tax revenues than to the exercise of the taxing power of the political unit involved, does not constitute a regulatory or enforcement power within the meaning of Rev. Rul. 60-384. See Rev. Rul. 74-15, 1974-1 C.B. 126.

Finally, on a Reg. 1.103-1(b) issue and not an exemption issue, Rev. Rul. 77-165, 1977-1 C.B. 21, considers a public university with a governmental power limited to preserving order and providing for public safety within the confines of its own real property, such as policing and traffic control on the campus. The revenue ruling holds that the organization's powers are insufficient to constitute the exercise of the state's police power.

Conversely, Rev. Rul. 74-14, 1974-1 C.B. 125, holds that a public housing authority formed to investigate whether unsanitary or unsafe housing conditions exists does not qualify for exemption under IRC 501(c)(3). In this case, the housing authority has the power to conduct investigations by entering property and issuing subpoenas. Further, it is authorized to make the information it collects available to other agencies for use in enforcing local ordinances. The power to subpoena involves the power to compel testimony under threat of imprisonment if the testimony is not forthcoming. The power to punish is a power of the state alone. In this case, the housing authority's powers are not limited to those needed to protect its proprietary interests. It possesses powers more related to governance than to the furtherance of a charitable purpose. Thus, Rev. Rul. 74-14 concludes that the housing authority's investigative powers are enforcement or regulatory powers within the meaning of Rev. Rul. 60-384.

All the facts and circumstances with regard to a particular organization must

be considered to determine whether that organization has powers that would enable it to carry out purposes beyond the scope of the purposes specified in IRC 501(c)(3).

The 1984, 1987, and 1990 CPEs contain articles that discuss whether particular powers are disqualifying for purposes of IRC 501(c)(3). IRM 7751-34(12)2.6, Exempt Organizations Handbook, also provides a discussion of disqualifying powers.

Although we continue to see cases involving different types of sovereign powers, problems in the power to tax area are seen most frequently. Accordingly, the following discussion will focus on the power to tax.

In determining whether an organization possesses the power to tax, consideration of the documents creating the organization, as well as the state statutes pertaining to the organization, is necessary. Consideration of state statutes should include, but not necessarily be limited to, the provisions specifying the powers granted to an organization's governing board and the method used to certify a tax. The following discussion is intended to address frequently encountered power to tax situations.

Question 1 Does a library that has the power to determine the rate of taxation necessary for its proper operation within stated limits possess an enforcement or regulatory power of the type described in Rev. Rul. 60-384?

Answer Rev. Rul. 74-15 describes a public library organized as a separate entity under state statutes with a limited taxing power necessary to fund its operations. The Revenue Ruling holds that the public library's power to determine a tax rate subject to specified limits set by the state legislature and subject to certification by the county board does not amount to a disqualifying regulatory or enforcement power. The effect of the state statute is not to grant the library the power to impose or levy taxes. Accordingly the library qualifies for exemption under IRC 501(c)(3).

Question 2 A hospital district is formed to advance the health of individuals residing within a specific county. The hospital district has no authority under state statute to levy, impose or collect a tax. Although

it is funded in part by income from taxes, the taxes are levied, imposed and collected by the county on behalf of the hospital district. Does this entity possess a disqualifying power of the type described in Rev. Rul. 60-384?

Answer No. Although the hospital district is the recipient of tax revenues, the power to levy, impose and collect taxes is with the county.

Question 3 A hospital district is formed to advance the health of individuals residing within a specified district. The hospital district has the power to determine a tax rate necessary to fund its operations subject to specified limits set by the state legislature and subject to certification by the county board. In addition, state statutes authorize the hospital district to provide for the appointment of a tax assessor-collector or to contract for the assessment and collection of taxes. Does the hospital district possess a disqualifying power of the type described in Rev. Rul. 60-384.

Answer The hospital district possesses the power to collect the taxes and has the inherent enforcement rights that comes with collection. Thus, it possesses disqualifying powers of the type described in Rev. Rul. 60-384.

Question 4 A hospital district is formed to advance the health of individuals residing within a specified district. The hospital district has the unlimited power to levy, impose and collect taxes it believes are necessary to support its operations. The library is not subject to any limitations with regard to the amount of tax it may levy or impose, nor is the rate it sets subject to certification by any county board.

The hospital district represents that it has never exercised its power to levy, impose or collect taxes and indicates that it has no plans to do so in the future. Will the hospital district qualify as an organization described in IRC 501(c)(3)?

Answer The hospital district will not qualify for exemption under IRC 501(c)(3). Regardless of whether it exercises the power to levy, impose, and collect taxes, it possesses such power. Thus, it has powers outside the scope of those described in IRC 501(c)(3) and fails the organizational test described in Reg.

1.501(c)(3)-1(b)(1)(i).

Question 5 A community development authority created pursuant to state law lacks the power to impose a tax. However, the authority is authorized under state statutes to impose, collect and receive service and user fees to cover the costs of carrying out the purpose of developing new communities. The authority may collect fees by three methods, an income charge, a flat fee, or a valuation charge. Does the authority possess enforcement or regulatory powers of the type described in Rev. Rul. 60-384?

Answer No. The authority's power to impose and collect service and user fees is not analogous to the power to tax, which must be clearly delegated by state statute.

6. Summary

A determination of whether an organization actually is a separately organized entity, other than an integral part of government, meets the organizational test, and does not possess a disqualifying regulatory or enforcement power can only be made after careful consideration of the language contained in its enabling instrument and, frequently, by reference to state or local statutes or ordinances that establish or regulate the organization. All pertinent provisions of such documents must be considered to make the right determination.

At this time, the discussion of the regulatory power of taxation fairly represents the position of the Service. However, we are considering several cases that do present novel questions involving the taxation powers including how exactly to distinguish a power to merely recommend a tax rate from a power to levy, assess or impose taxes. We are also reviewing the conditions under which certification of a tax rate to a public authority represents a crucial factor in this decision. We hope to be able to provide additional guidance in this area.